



November 7, 2000

Vice Chairman
Federal Home Loan Bank

RE: Purchase of Insurance Annuity Contracts (2000-APP-10)

Dear Mr. :

This is in response to your letter dated August 18, 2000 (August letter), concerning a request for Federal Housing Finance Board (Finance Board) approval of a proposed purchase of insurance annuity contracts intended to provide supplemental compensation for certain senior officials of the Federal Home Loan Bank (FHLBank) (request for approval). The FHLBank initiated the request for approval in a letter dated May 15, 1999 (original request). In response, by letter dated November 22, 1999, Finance Board staff requested additional material concerning the following issues: (1) an opinion from the FHLBank general counsel that fiduciaries are authorized to invest in annuities under state law; (2) specific reasons for the structure of the proposed annuity purchases; (3) a description of the vesting plan for the insurance; and (4) an exact accounting of the financing proposals.

In response, the FHLBank's August letter contained: 1) an opinion from the FHLBank General Counsel that, under state law, fiduciaries may invest trust funds in annuities if the actions of the fiduciary in managing the funds comply with the prudent investor standard; 2) an assertion that the Federal Home Loan Bank Act, as amended, authorizes the FHLBanks to establish compensation plans without the prior approval of the Finance Board; 3) an argument that the proposed transaction does not include an annuity; and 4) a description of the accounting treatment. Based on a review of this response, Finance Board staff has concluded that the August letter addresses some, but not all, of the issues raised in the Finance Board's November 22nd letter. The purpose of this letter is to advise you that the FHLBank must seek a waiver of the investment restrictions set forth in the Financial Management Policy (FMP) with respect to the proposed purchase of "Key Person Insurance" coverage that extends beyond the term of employment of the covered employee.

It appears that no substantive changes in the structure of the insurance contracts have been made since the original request was submitted to the Finance Board. The argument that the proposed transaction does not include an annuity lacks support. "Key Person Insurance" coverage that would extend beyond the employment period and provide for a payment of benefits to the FHLBank well after the covered employee terminated their employment constitutes both an annuity and an investment by the FHLBank. The FMP does not recognize such an investment. Additionally, the FHLBank's claim that the "Key Person Insurance" allows them to recover their expense does not take into account the time value of money, *e.g.*, insurance policies have a loading to cover the insurer's overhead and cost of capital. The FHLBank has not yet submitted any explanation of how the FHLBank would recoup the differential between its costs and the projected recovery.

The FHLBank may not proceed with this investment in the absence of a waiver from the Finance Board. The FHLBank may seek such a waiver pursuant to the Finance Board's procedural regulation set forth in 12 C.F.R. part 907. In order to address the outstanding issues, the request for a waiver should include a concise statement of: (1) the specific reasons for the structure of the proposed annuity purchases; (2) an accounting of the FHLBank's expenses that would be recouped; (3) an estimation of the range of potential coverage outcomes under various factual scenarios (*e.g.*, from the FHLBank's perspective all of the potential situations under which the FHLBank would expect to be compensated under the policy); (4) the amount of capital that the FHLBank would hold against the investment; and (5) an exact accounting of the financing proposal. Additionally, the request should provide the FHLBank General Counsel's opinion on authorized investments under state law, which previously was provided to staff. Finally, the FHLBank should describe the information provided to the FHLBank board of directors, and provide copies of the materials submitted to the FHLBank board of directors, in connection with their consideration and approval of the proposed insurance policy purchases.

If you have any questions concerning this matter, please contact Art Hogan, Office of Policy, Research and Analysis, 202/408-2975. Questions concerning the procedures for filing a request for a waiver under the Finance Board regulations may be directed to Charlotte A. Reid, Special Counsel, Office of General Counsel, 202.408-2510.

Sincerely,

/s/ James L. Bothwell

James L. Bothwell
Managing Director

cc: Scott L. Smith
Deborah F. Silberman
Mitchell Berns